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A Bank for All Seasons: The Bank of Canada and the Regulatory Challenge

By
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- Many financial systems around the world have, in the past two years, neared collapse – Canada's has also suffered because of home-grown problems.
- How to go about securing more stable financial structures has therefore become a vital worldwide concern; given the political, regulatory and technical obstacles involved, progress will not be easy.
- The Bank of Canada must come to play a recognized, central leadership role in shaping policy if Canada is to better manage risks to financial sector stability. This can be accomplished by giving the Bank a clearly acknowledged oversight and investigative mandate regarding financial stability – which would not require statutory change – linked with the responsibility to report independently on the same.

In the wake of blows to so many countries' financial systems, how best to manage them has become a hot and contentious topic, with a significant part of that debate focussing on the role that central banks in particular should play. This question has also begun to gain attention in Canada, and in this *e-brief* I want to contribute to that process by outlining a better role for the Bank of Canada in managing risks in our financial system – in the interests of improving the system's risk management generally.[1]

First, some context for the discussion. Financial regulation comprises two basic fields – prudential, that is, institution risk-taking and risk-proofing matters; and market conduct, principally proper disclosure for consumers of financial products. The concern here is mainly prudential regulation.

Two terms now frequently employed in discussing financial regulation are 'systemic risk' and 'macro-prudential.' These are two facets of the same broad concern. Systemic risk relates to both how risk is distributed across the financial system at any time ('cross-section') and how this risk might develop over the economic cycle. A macro-prudential approach concerns itself with the regulatory and other policy implications of systemic risk, rather than with how regulation affects individual institutions. The latter is micro-prudential and clearly supervisory also. Macro-prudential can involve non-supervisors, especially central banks. Of course, the macro and micro can overlap. For example, we can ask whether certain

1 For a broad view as to the ways central banks are addressing drastically changed circumstances, including those for financial systems, see Crow (2009).

institutions are too big to fail (or in today's newspeak, whether they are 'systemically important financial institutions') and what issues for policy this might present. Given the size of our major financial institutions, this is a particularly relevant question for Canada.

Now to the issues. With the soul-searching as to what has gone wrong in financial systems, regulatory change is afoot, particularly in the United States and Europe. In Canada, there has been some satisfaction over the fact that our financial sector did not sustain big damage. Whether and in what measure this is because of good regulation and supervision, institutional conservatism or plain luck remains a matter for debate. In any event, the Canadian authorities have subscribed to the global consensus (G7/8, G20, Financial Stability Board, Bank for International Settlements etc.) that each nation's financial regulation needs serious review to ensure that the risks of future financial meltdown are at least mitigated, if not more. Furthermore, in Canada the collapse of the nonbank asset-backed commercial paper (ABCP) market in 2007 and its messy aftermath should have given policymakers ample pause.

"Not My Department"

Let me expand on this. The Office of the Superintendent of Financial Institutions (OSFI) has argued that, notwithstanding earlier outside warnings of the ABCP liquidity risks being run in the Canadian system, the fiasco was not something for which it bears responsibility. In essence, it has contended that its mandate calls upon it to focus on protecting banks and not on taking care of the system more generally.[2] Be that as it may, who else might be allocated some responsibility? Well, to some degree, provincial securities administrators, since prospectuses for the asset-backed paper might have done better in characterizing risks. And who is to ride herd on credit rating agencies and the incentives they face? It is also worth noting that in the ABCP episode the Bank of Canada, while not having any formal responsibility, played a vital leadership role in pulling the situation back from chaos and finding a defensible solution. In short, the ABCP affair poses some important questions regarding the coherence of risk management in the Canadian financial system as a whole – particularly regarding where responsibility lies, and who is expected to come to the rescue, and on what authority, when trouble occurs. Finally, what the ABCP episode also makes clear is that any serious attempt at tackling financial stability concerns calls for wide-ranging analysis and action that should not be dictated by particular regulatory boxes.

Inadequate to the Task

This brings me to the future. And here, it needs to be emphasized at the outset that the effort to make progress from where we are requires at its centre skill, readiness to explore across a wide range of issues and constituencies, and a willingness to speak up and the credibility to be listened to. Furthermore, in terms of what is now needed, current regulatory set-ups do not appear to fit the bill.

It is clear that the everyday financial industry coordinating mechanism that currently exists for Ottawa, the Financial Institutions Supervisory Committee (FISC), is not an adequate vehicle for dealing with systemic risk.[3] For one thing its chair, OSFI, has, as the ABCP affair demonstrated, a role that is conceived too narrowly to preside over systemic and macro-prudential matters. OSFI is also specifically federal in nature, which means it does not cover securities markets. They cannot be left out. The Senior Advisory Committee – whose membership comprises the same officials as FISC and is

2 A reader interested in pursuing this matter in more detail might consult Standard & Poor's (2002) and OSFI (2008).

3 The FISC is a creation of the OSFI's enabling legislation; the committee consists of OSFI's Superintendent, the Commissioner of the Financial Consumer Agency of Canada, the Governor of the Bank of Canada, the Chairperson of the Canada Deposit Insurance Corporation, and the Deputy Minister of Finance; it is chaired by the Superintendent.

chaired by the Deputy Minister of Finance – has a broader mandate, but is again exclusively federal. Finally, we have the Heads of Agencies (HOA) – an informal forum that reportedly "brings together" the OSFI Superintendent, the Finance Department, the heads of the B.C., Alberta, Ontario and Quebec securities regulators, and the Governor of the Bank of Canada (Chant, 2009). Indeed, based on media reports and reading between the lines (I was in Ottawa for 21 years), what one can see is an embryonic move to set up a broad committee of regulators – not just OSFI and Finance, but also securities regulators – together with the Bank of Canada, to address systemic issues.[4] This looks like a refurbished HOA.

This grouping is promising as regards institutional and market coverage. However, if Canada is serious about thinking through systemic risk matters, it needs more. Having a collegial committee is one thing. But having a body that is prepared to undertake challenging, focussed analysis and to follow through with an unvarnished presentation of systemic risk issues is something else. And if such a committee were to get no further than being a talking shop, with regulatory bodies concerned primarily to protect their turf and fence off their responsibilities, and therefore a substitute for serious leadership and action, the task is better undertaken without one.

Bolstering the Bank's Role

Given this very real concern, there is a great deal to be said for having the Bank of Canada play the central role in identifying and providing answers for potential risks to the financial system. What other Canadian institution could?

The Bank ought to have the sense of direction, intellectual capability and the ability to staff appropriately. It is already producing regular financial system reviews, which are in fact becoming sharper regarding stability issues. It has in principle enough independence to call matters as it sees them. Also, the record shows that it is hauled into managing financial stability issues generally, notwithstanding the fact that it has no jurisdiction over them. Finally, it has the international linkages and connections to be well informed and involved as regards the international regulatory scene in general, and international relationships for the financial sector in particular. For Canada, at best a medium-sized and very open economy, this is terribly important.

But how should the Bank relate to other Canadian institutions? My broad view is that it should be the chair for a consultative group – probably the same group as now constitutes the Heads of Agencies. Note, however, that this group would be there for consultation, not for control, with respect to what the Bank comes up with regarding financial stability issues. Naturally, members also might propose issues for the Bank's consideration and the Bank would of course be bound to consider them seriously. However, in the end, this would be a consultative body and the Bank would settle its priorities and timing.[5]

It would also be important, in solidifying the process, that the Bank be given a clearly acknowledged oversight and investigative mandate regarding financial stability – linked with the responsibility to report on the same. A statutory mandate from Ottawa would, under present constitutional arrangements, hardly cover the securities-related matters that fall to the provinces but are very pertinent to systemic risk questions. Still, the important element about such a mandate is not that it be statutory, but that it be generally understood and recognized as valid.

The Bank should also have ready access to relevant official information. In this regard, I have worried a lot over whether the approach sketched above requires the Bank to be a regulator/supervisor itself to be at all effective. My

4 What also comes across, at least from Ottawa's vantage point, is that if this move acts as a lever for provincial acceptance of a nationally based securities commission (like the Securities and Exchange Commission in the United States, for example), so much the better. Provinces may, of course, beg to differ on this.

5 Some observers have already emphasized that whatever new responsibility the Bank of Canada might undertake should be "coordinated" with existing bodies. Coordination is too limiting a concept if the Bank (or any individual institution) is to take the lead. I prefer "cooperation" – that is, making a point of listening to other views, exchanging views, but in the end retaining the freedom to make known on one's own initiative and authority what needs to be made known. As William Lawson, distinguished Senior Deputy Governor of the Bank, used to put it, "Listen to everyone but hold the pen yourself."

conclusion is that the issues regarding systemic risk are in fact rather broad, and that supervisory information will probably be a relatively minor part of what needs examination. Experience also tells me that what can be picked up through informal contacts, if one has the right network, is at least as valuable (and quite likely more so) as what is likely to be turned up through a formal supervisory process. Therefore, the Bank would have to invest significant time and effort in its financial advisory outreach and network. Nonetheless, for safety's sake, access to direct supervisory material, and indeed the right to observe OSFI etc. examinations, should be unquestioningly available.

What should the Bank do with the information it gathers and views that it forms? It should of course come up with careful analysis and concrete proposals. However, I do not believe it feasible or desirable for the Bank to have the power to impose regulations. In that sense, it would not be a regulator. But it should, again after appropriate consultation, have the explicit right to make its views on regulatory matters of systemic importance, and the analysis behind them, widely known. Put another way, no body, including the Department of Finance, should be able to veto or censor the Bank's dissemination of its views regarding financial stability issues. Also, the Bank should now be required to publish, say twice a year, the financial system review that it currently issues under its own initiative. This would further sharpen the discipline and authority of the process.

Of course, under this scheme regulators and supervisors would have the right to simply disregard the Bank's views and proposals on broad financial stability matters. However, that would be seen clearly as their choice, and their responsibility to justify, and not the Bank's. Also, it should be borne in mind that nothing proposed here prevents the operation of, for example, the Financial Institutions Supervisory Committee or the Senior Advisory Committee in the ways they have in the past. In short, there are plenty of filters.

What would be the criticism of the above? It could not be that the Bank is taking away from existing bodies their statutory authority – something against which in any case bureaucracies fight tooth and nail and generally win. Rather, it would be that the Bank is assuming some ill-defined though real responsibility, but without the authority to see it through to the end. There, I think one has to appeal to the Bank's capacity for serious, well-reasoned analysis, its independent pen, and the explicit recognition of its public oversight role in this broad area, as elements that will make a constructive and worthwhile difference – especially compared to the no man's land, in regard to systemic risks, that Canada inhabits now.

How large that difference will prove to be is something that time will have to tell. This is bound to be an evolutionary process. Also, bear in mind that the goal itself cannot be sharply defined, since the very concept of financial stability is ill-defined.[6] However, what I am suggesting would be an undeniably useful start on a real issue.

This is not a call for the Bank to take on the role either of supervisor or super-regulator. Rather, I see it being given a clear oversight and investigative role in regard to broad financial stability matters – meta-regulator would be an appropriate term. Other bodies would have the right to be consulted, but in a way that does not mean a veto. Some would have the obligation to cough up information if the Bank calls for it. In the end, however, the Bank would have the clear authority and responsibility to decide what needs to be tackled and to form and publish its own considered views on broad matters.

By way of conclusion, let me note that while this business may not be as pressing in Canada as, say, in the United States or the U.K., serious steps should be taken to deal with it. There are matters to address. Indeed, one obvious place to start would be for the Bank to analyze system issues, and possible responses, arising from the ABCP affair.

6 The best those in the field have been able to come up with as a definition of financial stability is the absence of financial instability.

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